



**TRUSTMAKERS &** Wealth Preservation Institute



CWPP Course:

**Certified  
Wealth  
Protection  
Planner**

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# CHARITABLE PLANNING



The Wealth Preservation Institute (WPI)

Creator of the following educational Certification Programs

Certified Wealth Preservation Planner (CWPP™)

Certified Asset Protection Planner (CAPP™)

## Course Objective

This course was created to educate CPAs accountants, EAs, attorneys, life insurance agents, and financial planners about “Charitable Planning.” This course will cover the major charitable planning solutions: Charitable Gift Annuities, Charitable Remainder Trusts, Charitable Lead Trusts and Family Foundations.

This course will teach the pros and cons of each of these planning strategies, and which type of charitable planning solutions should be used in various client situations. Additionally, this material will introduce advisors to the concept of “simplified planned giving” and how to incorporate a Donor Advisory Fund into a non-family foundation so the heirs can have input as to where the charitable donations will be distributed.

# Charitable Planning

## Introduction

While there are many advisors around the country who specialize in charitable planning, as a general statement, most advisors have only a cursory knowledge of the topic and do not actively address it with their clients.

Most professionals strive to be the best at what they do. The problem today is that everyone is so busy, it is difficult to keep up on the changes to topics advisors currently deal with, let alone learn new topics that can benefit their clients.

In this material, you will learn in plain English the main charitable options available to several different types of clients. Not only will this material teach readers about charitable planning, but it will also introduce to advisors what is called “simplified planned giving” (a more efficient and painless way to implement charitable planning).

## Interesting Statistics

“Charities stand to gain \$6-trillion to \$25-trillion in bequests over the next 50 years, say Boston College scholars who issued a study on the so-called intergenerational transfer of wealth.” (Source: The Chronicle of Philanthropy, 10/20/1999)

-In 2004 Americans will donate \$160 billion to non-profit organizations.

-Corporations will donate another \$80 billion (Source: *Forbes Magazine* Jan 12, 2004, p.36)

Recent surveys show that there is a disconnect between advisors and their clients in this area.

- Some 70% of households donate money to charity annually
- Only 35% of the total goes to churches
- 6% make testamentary gifts
- Less than 5% of advisors discuss philanthropy with their clients

## **Why don't more clients implement planned giving into their financial plans now?**

If more people (advisors and clients) knew about "simplified planned giving" (SPG), many more charitable plans would be setup each year.

### **Traditional Planned Giving**

- Charity centered
- Expensive
- Complicated
- Sensitive to market
- Difficult to deliver
- Marginally profitable for advisor

### **Simplified Planned Giving**

- Donor/client centered
- No out of pocket cost
- Fire and Forget
- Guaranteed benefits
- Quick implementation
- Very profitable with seamless integration

Most clients do not implement planned giving into their financial plans because **they don't know that they can (while still accomplishing their ultimate goal of passing wealth to the heirs)**. Whose fault is it that our clients do not know much about charitable planning and simplified planned giving? The honest answer is that it is a client's CPA/accountant, attorney, financial planner and insurance advisor. Everyone one is so busy that few have time to learn charitable planning in depth to give competent advice to clients.

## **Who will serve this \$25 trillion market?**

Advisors who can: Assess client needs and desires; educate clients on Simplified Planned Giving (SPG) benefits; network with a SPG support system; keep it simple; and of course keep it simple.

Simplified Planned Giving is a process which allows financial service professionals to seamlessly add planned giving to their practices and introduce this tremendous philanthropic opportunity to clients who would not normally consider participating in the complexity and expense of typical charitable planning.

It is important to note that SPG is not a new tool, but a tried and true series of planning methods. For the insurance advisor, SPG is not only good for the client, but also for the advisor since it can create new life insurance and annuity product sales. New programs have been developed that condense effective life income plans and split interest gifts into powerful charitable planning solutions. Both the Charitable Gift Annuity (CGA) Program and the Charitable Remainder Annuity Trust (CRAT) Program are simple to learn, use, and implement.

## **Objectives**

Each charitable program is designed to address a wide range of planning objectives, including securing lifetime income, managing taxes, protecting families and supporting charitable causes. Because of the simplicity, flexibility and tremendous benefits provided by these programs, there are literally countless applications.

## **Opportunity**

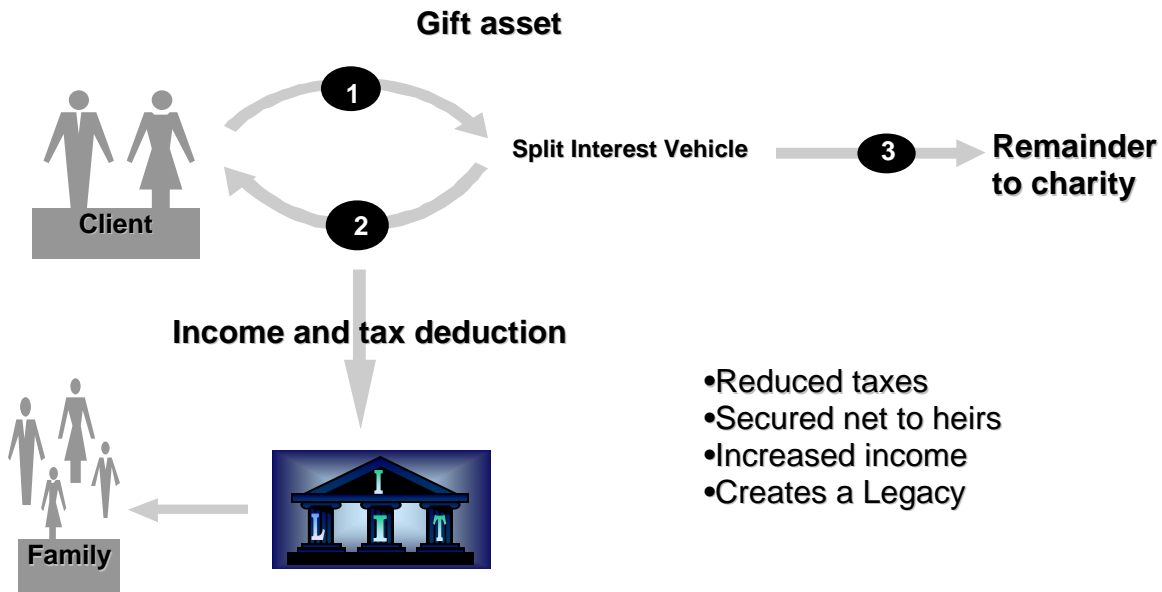
Many professionals are seeking opportunities to expand the services offered to clients. More and more clients are looking for powerful solutions to their financial and estate planning problems that will address all of their concerns. Studies indicate that over 70% of American households currently make charitable gifts throughout the year. A significant amount of these will be gifted in exchange for the “living benefits” associated with Simplified Planned Giving (SPG).

## **Understanding the Benefits**

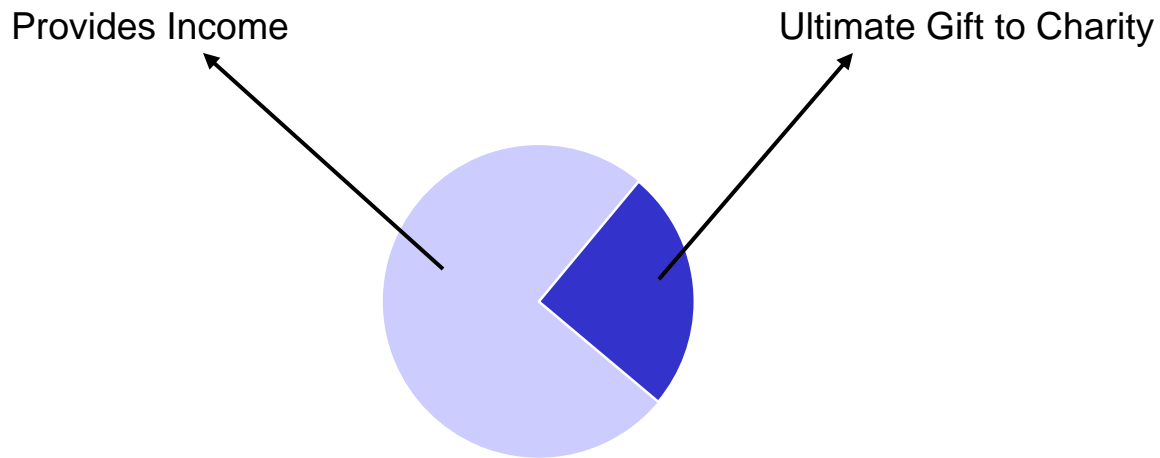
SPG programs use life income plans and split interest gifts to help meet client objectives. This results from a charitable gift in which a donor retains an interest, typically through lifetime income payments while providing a tax deduction. In the process, the charity receives a remainder value to use for its own purposes. Such gifts can provide many attractive benefits to potential donors. Therefore, to sort through your client base and present options, you must first learn the various benefits. In general terms, those benefits include:

1. Increasing discretionary (“spendable”) income
2. Reducing or eliminating income taxes, capital gains taxes, and estate taxes
3. Securing a tax free inheritance for chosen heirs
4. Leaving a lasting family and social legacy

## Split Interest Gift Overview



## Asset(s) Value



- Provides for lifetime income
- Generates an income tax deduction
- May reduce/eliminate IRD tax burden
- Removes asset(s) from taxable estate
- May provide capital gain tax relief at transition
- Supports charitable causes

## Recognizing Charitable Intent

As great as the benefits of Simplified Planned Giving are, establishing charitable intent is still an integral part of identifying potential clients. The good news is that recent surveys indicate that over 70% of American households regularly donate to charity. However, few are aware of the benefits of life income plans, split interest gifts, or other forms of planned giving.

For most, charitable giving consists of writing a check to a local charity/church or participating in the United Way drive at work. The average American would have difficulty naming ten charities, but typically has one or two causes close to heart. Many SPG program participants started with no specific charitable intent at all. However, they all were very interested in one or more of the income and/or tax benefits available.

Few people wake up in the morning and decide to give money to charity. However, many clients, once they have been educated about the living benefits of SPG, realize that they can meet their financial objectives AND support their favorite charitable causes at the same time. For such clients, charity truly begins at home.

## Charitable Gift Annuities (CGA)

Charitable gift annuities are among the oldest and most respected methods of charitable giving, with the first annuity having been issued by the American Bible Society in 1843. Charitable gift annuities currently play a prominent role in the planned giving programs of numerous reputable charitable organizations across the nation.

Each year thousands of Americans make generous gifts by creating charitable gift annuities. In so doing, these donors are able to support churches, schools, and other charitable organizations of their choice while enjoying the significant financial advantages of a charitable gift annuity. With proper planning, many common financial objectives, such as increasing income, reducing taxes, securing value to heirs, and creating a lasting social legacy, can be met and even exceeded with the use of a charitable gift annuity.

### CGA Quick Facts

- A charitable gift annuity is a contract between a donor and a qualified 501(c)(3) public charity.
- The donor makes an irrevocable gift to the charity in exchange for a promise of lifetime income.

- Income may begin immediately, **or can be deferred for a period of at least one year**, depending on donor preference.
- Typically, the lifetime income is paid to the donor or to donor and spouse (joint and survivor).
- The charity pays the donor(s) for life either monthly, quarterly, or annually, at an agreed upon rate. Once reserve or reinsurance requirements to guarantee payments to the donor have been satisfied, the charity uses whatever remains from the original gift for its charitable purposes.
- Some charities allow a portion of this “charitable remainder” from the CGA to pass into a client/donor’s Donor Advised Fund (DAF).
- The American Council on Gift Annuities (ACGA) establishes maximum rates to be used by charities in determining the payout rates of a CGA, thus preventing “bidding wars” for donor’s dollars.
- A CGA can provide lifetime income at a high rate that is guaranteed by the charity, and an immediate tax deduction for the donor.
- The CGA Program is an effective tax and income-planning solution for many clients with highly appreciated assets and deferred annuities, the type of clients you meet every day.

## Substantial Tax Benefits

There are three primary ways in which a CGA can assist in tax management. First, when transitioning the ownership of a highly appreciated capital asset (marketable securities, real estate, business interests, etc) to a charity in exchange for a CGA, the donor does not realize a lump sum capital gain distribution. **The capital gain is reduced significantly and then amortized over the donor’s life expectancy.** This means that a portion of the donor’s CGA income will be taxed at the lower capital gains rate.

Second, a substantial **immediate income tax deduction** is given, which can be used to offset current income taxes up to a certain amount based on adjusted gross income. Any surplus deduction can be **carried over up to 5 additional years.** The amount of the tax deduction is based upon the projected value of the ultimate gift to charity.

Third, transferring an asset to a CGA removes the asset from the donor’s taxable estate, which can greatly reduce potential estate taxes. In some cases, depending on the type of asset, transferring an asset can also avoid income with respect to a decedent (IRD) taxation at estate settlement.

## Guaranteed Benefits – Income

When entering into a CGA contract, most donors want to make sure that the charity has a safe method of protecting funds that will be used to make their lifetime income payments. Charities are required to maintain certain reserve requirements, and may also be mandated to invest funds according to strict parameters, depending on state requirements. Even with these safeguards, many charities **take additional precautions with a CGA by using a portion of the gift to purchase a single premium immediate annuity (SPIA)** for the life of the donor(s) from a highly rated commercial insurance carrier. In essence, this allows the charity to pass interest rate, investment and mortality risks to an insurance company.

In practical terms, it also allows the charity to continue about its real work without having to worry about investment performance or market fluctuations. Commercially insuring a charity's obligation to a donor in this manner is known as "reinsurance" or an "insured benefit". Some charities do not take the extra steps to reinsure income obligations to donors, investing gifted funds instead hoping their investments will yield higher returns and/or that donors die sooner than life expectancy. But if the investments do not perform well, or donors live beyond their normal mortality, a charity could be forced to use other funds or face being unable to pay its CGA donors.

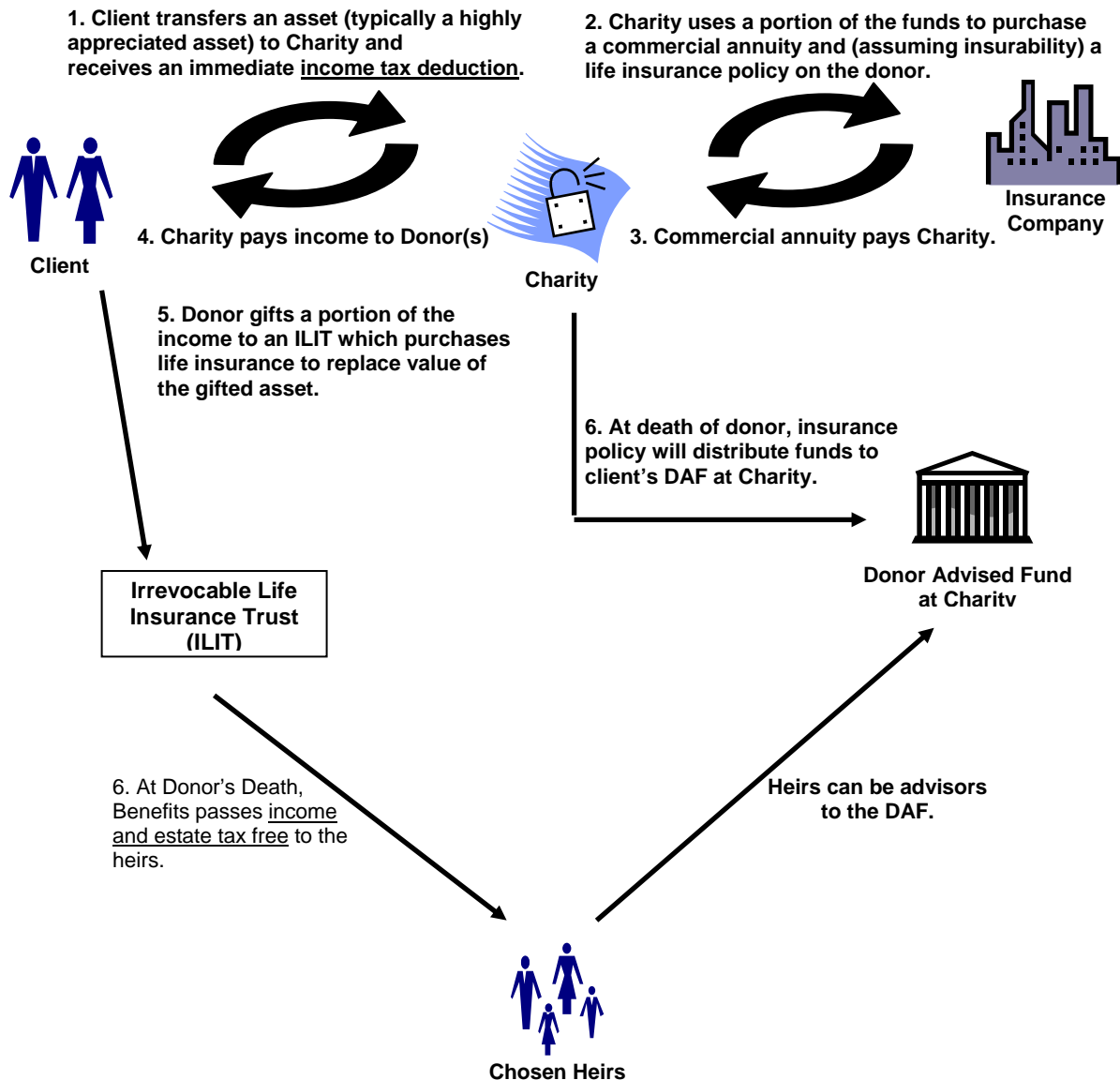
It is important to work with a CGA program that will protect your client's lifetime income by working only with qualified charities that are willing to utilize this extra measure of protection by purchasing commercial annuity contracts to back their income payment obligations ("reinsure"). The charity can purchase the commercial product(s) directly from the client's licensed advisor. Or, if you and your client prefer and the charity is agreeable, another investment method can be implemented.

## Guaranteed Benefits - Charitable Legacy

A charity that has "reinsured" its payment obligation to a donor and met its necessary reserve requirements can use the remainder of the gift for its charitable purposes. Some charities allow all or a portion of this remainder to be designated for a Donor Advised Fund that is funded at the death of the donor(s). This permits the donor to have some say, in an advisory capacity, as to how the charitable funds are used, and provides an excellent method of establishing a legacy.

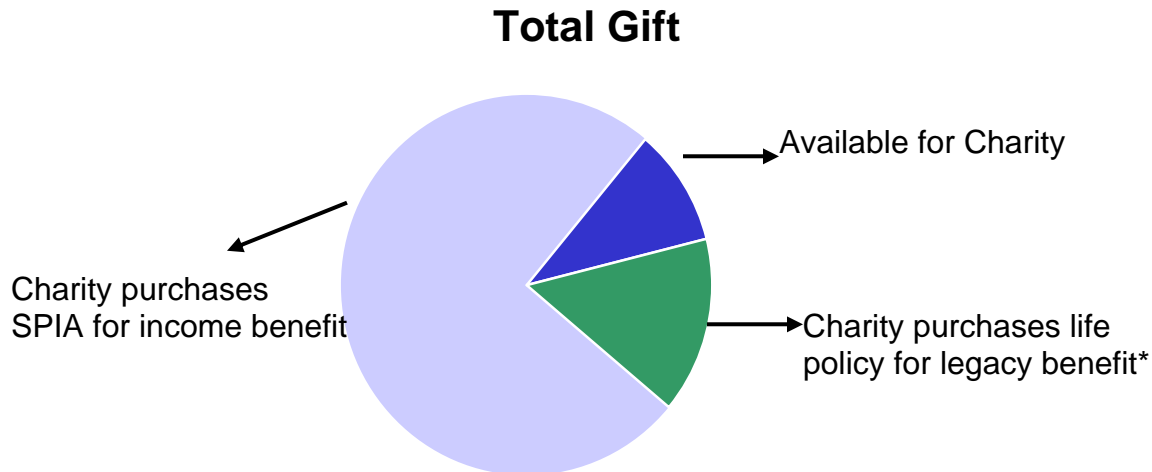
A good CGA program provides these benefits by working only with qualified charities that, in addition to “reinsuring” income obligations, are also willing to allocate a portion of the charitable remainder to a Donor Advised Fund. When charities (and donors) are willing, these funds can be invested in life insurance or annuity products to dramatically increase the DAF value at the death of the donors. The charity can purchase commercial product(s) directly from a client’s advisors who is properly licensed. Or, if you and your client prefer and the charity is agreeable, another investment method can be implemented

## Charitable Gift Annuity Program Schematic



## CGA Program Insured Benefits

1. Guaranteed Income Benefit
2. Legacy Benefit (DAF)



\*If underwriting considerations are not favorable, charity may select an annuity settlement option or fund a deferred annuity to provide the legacy benefit.

### Immediate Income CGA

- Improve lifestyle-enhancing income
- Generate income to cover LTC expenses
- Unlock an under-performing capital asset
- Many other planning solutions

### Deferred/ Build-up Deferred

- Supplemental Retirement Income Plan
- Tax Deduction now, income later

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## Charitable Remainder Trusts

### Charitable Remainder Annuity Trust (CRAT) Program

Charitable remainder trusts are among the most well known of all charitable planning tools. They have been effectively used for decades allowing clients/donors to support worthy charitable causes while enjoying income and tax benefits. Charitable remainder trusts are, however, not without their potential flaws. Some of these include relatively high startup costs, attorney's fees, administrative fees, ongoing tax filings and administration burdens, investment costs, and market risks and fluctuations.

Because this material is supposed to put forth the best possible options for clients, we will cover only what is known as the ezCRAT™ Program (Easy Charitable Remainder Annuity Trust). The ezCRAT™ eliminates the above mentioned concerns with a low-cost, turnkey solution that provides guaranteed income and legacy benefits for your clients. The ezCRAT™ Program is an especially effective tool in those states wherein the use of a Charitable Gift Annuity is difficult.

Each year thousands of Americans make generous charitable gifts by creating charitable remainder trusts. In so doing, these donors are able to support churches, schools, and other charitable organizations of their choice while enjoying the significant financial advantages of a charitable trust. With proper planning, many common financial objectives can be met and exceeded with the use of a charitable remainder trust such as increasing income, reducing taxes, securing value to heirs, and creating a lasting social legacy.

## **ezCRAT™ Program Highlights**

- The ezCRAT™ is an effective tax and income planning solution for many clients with highly appreciated assets and deferred annuities, the type of clients you meet every day.

- The ezCRAT™ provides guaranteed income, an immediate tax deduction, and a guaranteed charitable gift to the client/donor's Donor Advised Fund (DAF) or desired charity. (The DAF makes the ezCRAT™ a fairly unique program in the CRAT marketplace).

- The ezCRAT™ is owned by the client, who serves as Trustee. The administrator of the Trust handles all administrative functions throughout the life of the trust, including annual tax filings, thus relieving your client from the hassle of ongoing maintenance commonly associated with charitable remainder trusts. A one-time, initial administrative fee, which can be paid from initial trust funds, is the only cost associated with the ezCRAT™ and will not affect your client's payout rate.

- The ultimate charitable beneficiary is your client's charity of choice or DAF sponsored by and offered through a qualified 501(c)(3) public charity. This will allow your client to select and direct which charities will benefit and how they will benefit. An ezCRAT™ can provide lifetime income at a high rate and an immediate tax deduction for the donor.

## **Substantial Tax Benefits**

There are three primary ways in which the ezCRAT™ Program can assist in tax management. First, when transitioning the ownership of a highly appreciated capital asset (marketable securities, real estate, business interests,

etc) to a charitable trust, the donor does not realize a lump sum capital gain distribution. The capital gain is reduced significantly and then amortized over the donor's life expectancy. This means that a portion of the donor's ezCRAT™ income will be taxed at the lower capital gains rate.

Second, a substantial immediate income tax deduction is given, which can be used to offset current income taxes up to a certain amount based on adjusted gross income. Any surplus deduction can be carried over for up to 5 additional years. The amount of the tax deduction is based upon the projected value of the ultimate gift to charity.

Third, transitioning an asset to an ezCRAT™ removes the asset from the donor's taxable estate, which can greatly reduce potential estate taxes and assist clients who have asset protection concerns. In some cases, depending on the type of asset, transitioning an asset can also avoid income with respect to a decedent (IRD) taxation at estate settlement.

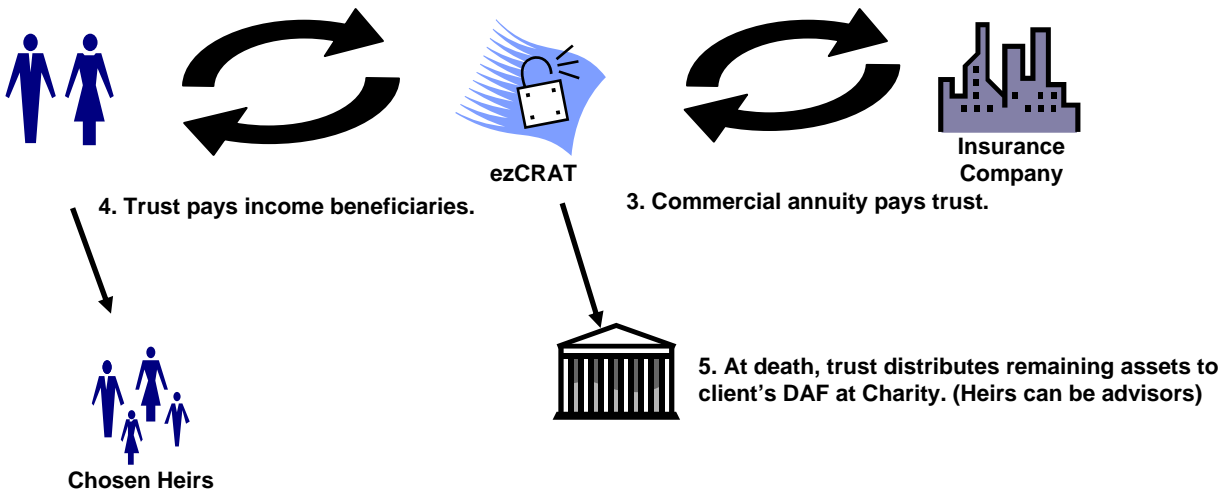
## Guaranteed Benefits

The ezCRAT™ guarantees your client's lifetime income by purchasing a commercial annuity from a highly rated insurance company. The ezCRAT™ also guarantees the amount that will fund the client's DAF or gift to charity by purchasing from a highly rated company either a life insurance policy (assuming insurability) or a deferred annuity. The ezCRAT™ can purchase these products from any advisor, as long as they are properly licensed and offer products that meet the needs of the Trust. If a client prefers, another investment method can be implemented to fund the amount that eventually goes to the client's DAF or to charity.

## ezCRAT™ Program Schematic

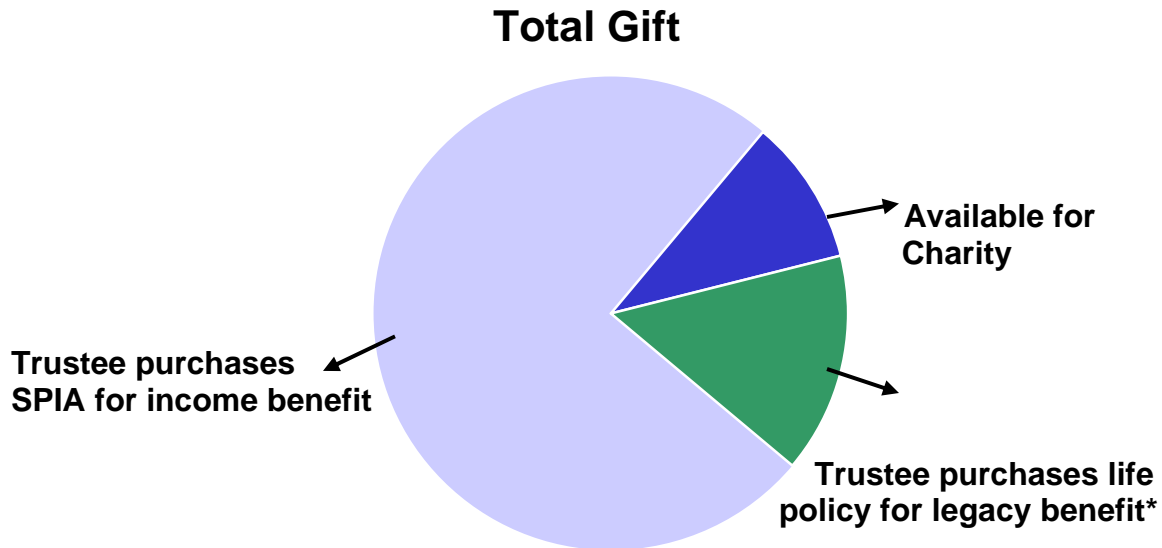
1. Client transfers asset to ezCRAT (trust).  
Receives immediate income tax deduction

2. Trustee uses a portion of funds to purchase a commercial annuity and (assuming insurability) a life insurance policy from licensed advisor, and pays one-time administrative costs.



ezCRAT™ Program Insured Benefits

1. Guaranteed Income Benefit
2. Legacy Benefit (DAF)



\*If underwriting considerations are not favorable, trustee may select an annuity settlement option or fund a deferred annuity to provide the legacy benefit.

**Program Comparisons**

Features	CGA	ezCRAT
Fixed guaranteed income	Yes	Yes
Income partially tax-free	Yes	Yes
Charitable tax deduction	Yes	Yes
More than two annuitants	No*	Yes
Income deferral opportunity	Yes	No
Asset ownership	Charity	Trust
Requires administrator	No	Yes**
Free of out-of-pocket costs	Yes	No***

\* Can be achieved with multiple contracts

\*\* Administration provided by professional administrator

\*\*\* One-time Admin fee of \$1000 can be paid out of pocket, or from trust funds

## Special Opportunities

- Advanced income and tax planning
- Enhanced “Split Annuity”
- Asset preservation (Medicaid Planning)
- Deferred annuity income tax time bomb
- Thawing a frozen capital asset
- CRT rollout
- Tax advantaged IRA/QP distributions
- Personal-deferred compensation

## Examples

### Example 1

**Background information:** Husband and wife in average health, both age 72

Family home	\$ 200,000
Personal assets	\$ 50,000
CDs (paying 3%)	\$ 100,000
Deferred Annuity	\$ 200,000
<u>IRA</u>	<u>\$ 100,000</u>
<b>Net Worth</b>	<b>\$ 650,000</b>

Wife’s teaching pension	\$ 22,000
Husband’s part-time job	\$ 8,000
CD income	\$ 3,000
IRA (taking minimum distribution)	\$ 7,000
<u>Social Security income</u>	<u>\$ 15,000</u>
<b>Current Annual Income</b>	<b>\$ 55,000</b>

### Objectives:

- Greatly concerned about Long Term Care and Medicaid Spend-down requirements.
- Like the protection of their CD investment, but aren’t happy with the relatively low return.
- Want to make sure they are “tax efficient” by handling pending IRD taxes on the gain in the annuity.
- Desire to pass as much value to their children.

Note: they had no specific desire to support charitable causes, but if they could achieve their other goals, they then wanted to help children’s causes.

### With Simplified Planned Giving?

When the clients traded the Deferred Annuity (\$200,000) for an Immediate Income CGA:

- They increased annual income by \$15,000 **guaranteed, for both of their lives.**
- They opted to use \$5,000 of this annual income to fund a **Long Term Care** plan.
- They opted to use \$6,000 of this annual income to fund a wealth replacement life insurance policy that will pay \$300,000 **tax-free** to their children.
- They still have an extra **\$4,000 in surplus annual income** vs. previous situation.
- They received an immediate tax deduction of just under \$86,000, which completely wiped out the taxes due on the gain in the annuity, and gave them additional tax deductions to use over five years.
- They established an \$85,000 Donor Advised Fund that will support their favorite charitable causes once they have passed on.

**Note: They were not *wealthy*, but were able to realize the benefits of Simplified Planned Giving.**

Results: 1.Increased Income; 2.Minimized Taxes; 3.Secured Value to Heirs;  
4.Created a Legacy

### Example 2

**Background information:** Husband and wife in average health, both age 73

Family home	\$ 250,000
Personal assets	\$ 75,000
Stock Portfolio (\$200 K basis)	\$ 500,000
IRA	\$ 200,000
<b>Net Worth</b>	<b>\$ 1,025,000</b>

Husband's pension	\$ 25,000
Stock Portfolio Dividends (1.5%)	\$ 7,500
IRA (taking minimum distribution)	\$ 14,000
<u>Social Security income</u>	<u>\$ 15,000</u>
<b>Current Annual Income</b>	<b>\$ 61,500</b>

**Objectives:**

- Eliminate worry over stock portfolio risks
- Find some tax relief in the portfolio gain
- Increase current income for “fun money” to travel, and enjoy their family
- Avoid becoming a burden to children
- Continue to support Ronald McDonald House Charities and their local library

Note: They have a strong relative net worth but a marginal lifestyle. The tax concern causes them to be “held hostage” by a portfolio producing low, fluctuating and fully taxable income.

**With Simplified Planned Giving?**

When the clients gifted the \$500,000 low basis stock in exchange for an immediate income CGA:

- They increased annual income by \$23,000 **guaranteed, for both of their lives.**

- A portion of their income is completely tax-free, and a portion is tax-favored.

- They received an immediate tax deduction of \$147,445, which they can use now to offset other income, make additional distributions from their IRA, or carry over for 5 additional years.

- They increased the estimated inheritance for their children by \$200,000.

- They established a \$150,000 Donor Advised Fund that will support their favorite charitable causes by making an annual gift of \$7,500 in perpetuity.

**Note: They were not *wealthy*, but were able to realize the benefits of Simplified Planned Giving.**

Results:

1. Increased Income; 2. Minimized Taxes; 3. Secured Value to Heirs;
4. Created a Legacy.

Besides offering guaranteed income benefits, our CGA and ezCRAT Programs allow your client to participate more fully in philanthropy through the establishment of a donor advised fund on his or her behalf.

The tremendous income benefits of these programs, joined with the substantial tax benefits and the legacy opportunities of the donor advised fund yield a powerful charitable solution for your clients.

## Wealth Replacement

Many clients do not have a charitable intent. However, for those who are on the fence, one way to rationalize using a charitable planning is to implement a “wealth replacement” strategy.

Wealth replacement is a fancy term for buying life insurance with some or all of the income stream that flows to the donor from the CGA. The theory is that a client can give away a \$500,000+ asset to a charity, get a current income tax deduction, and use the stream of income from the Charity to purchase a \$500,000+ life insurance policy inside an irrevocable life insurance trust (ILIT). This policy would typically be purchased inside an ILIT so the death benefit will pass income and estate tax free to the heirs.

### Example:

Assume that Dr. Smith age 60 has an estate of \$5 million at the age of 60. The \$5 million estate is made up of a home worth \$1 million, a brokerage account worth \$1.65 million, an IRA of \$1.5 million, a vacation condo worth \$350,000, and a rental property worth \$500,000. The rental property has a basis of \$100,000. Assume Dr. Smith still works as a surgeon where he makes \$400,000 a year.

Dr. Smith has three children and five grandchildren, and he and his wife would like to leave something to charity so they can teach their children about those who are less fortunate by having them involved in charitable giving through the DAF.

Dr. Smith decides to implement a CGA, and it would work as follows:

1) Dr. Smith gifts the \$500,000 rental property to a charity which sells the property for \$500,000 (and the charity pays no capital gains).

2) Dr. Smith receives an income tax deduction for his tax return of \$60,925 (saving him \$24,370 in income taxes on his current year’s tax return). This deduction could be increased substantially if Dr. Smith waited to receive income payments from the CGA. Also, if he was older when making the gift, the income tax deduction would be larger (in our example the deduction if he was age 65 would be \$89,890).

3) The charity buys a single premium lifetime annuity on Dr. Smith and starts paying him \$28,000 in income each year until his death. The first year, \$14,515 of the payment is taxable at the long term capital gains, \$13,216 is treated as ordinary income and \$269 is tax free. The taxable consequences of CGA payments to Dr. Smith change during his lifetime and are not discussed for the sake of brevity.

3a) The charity also buys a \$500,000 second to die life insurance policy on Dr. Smith and his wife that will fund the DAF at the last spouse's death.

4) Dr. Smith takes \$4,500 from the income he receives from the CGA each year and gifts that to an ILIT where a \$500,000 second to die life insurance policy is purchased. This death benefit will pass to the heirs income and estate tax free.

5) When Dr. Smith and his spouse die, \$500,000 will pass to their heirs income and estate tax free (thereby replacing the \$500,000 piece of real estate that would have passed to the heirs if it were not for the gift).

5a) The DAF is funded at the second spouse's death and that money will then be used in the DAF for charitable purposes with the help and direction of Dr. Smith's heirs.

Benefits of the above example:

Dr. Smith helped a charity by gifting it a \$500,000 asset; he received an immediate deduction for his current income taxes; his heirs did not lose the asset due to the fact that a \$500,000 life insurance policy in an ILIT was purchased with the income from the CGA; he removed a \$500,000 asset from his estate for estate tax purposes; and at Dr. and Mrs. Smith's death, the heirs became involved in the DAF that was funded from a life insurance policy that was purchased and owned by the charity.

## **Donor Advised Funds**

A donor advised fund (DAF) is a powerful yet simple charitable tool. Think of a DAF as a "subaccount" under the umbrella of a qualified 501(c)3 public charity. A donor can make a charitable contribution to a DAF and receive a dollar for dollar tax deduction (certain AGI limits may apply). As with most gifts to charity, the donor's involvement would end there. However, with a DAF the donor can retain some control, in an advisory capacity, as to how the funds are used and invested.

These funds can build and maintain low-cost endowments that support other charitable causes and they can greatly augment lifetime income and split-interest gift programs. They can support:

- Public charities
- Private charities
- Supporting organizations
- Private family foundations
- Colleges, universities, and other qualifying institutions

## **Quick Benefits of Donor Advised Funds**

There are few alternatives that offer the individual donor the versatility and tax efficiency of a donor advised fund. A donor advised fund is a simple and very effective way to give.

### **-Immediate tax deductions:**

Donations to a DAF are fully deductible in the tax year they are made.

### **-Avoidance of capital gains tax:**

Individuals can donate appreciated assets such as securities or real estate directly to the fund and realize their full value as a deduction without incurring any capital gains tax.

### **-Simple alternative to private or family foundation:**

A DAF eliminates the complexities, costs and administrative burden of operating a private foundation.

### **-Separation of tax planning and charitable decision:**

Immediate tax advantages can be achieved now and grants can be made to charities later.

### **-Flexibility in recommending grants:**

Donors can recommend grants to charitable organizations of their choice for the life of the account. Grants can be distributed with recognition of the donor or anonymously.

### **-A legacy of giving:**

Individuals can name multiple advisors and contributors to an account who will carry forward the legacy of charitable giving.

## How Donor Advised Funds Work

First, a donor makes an irrevocable gift of cash, securities or real property to a qualified public charity. Depending on where the DAF is established, the donor will also complete an application package at the time the initial gift is made.

The donor's Donor Advised Fund is then created under the name the donor has selected. An example of a typical DAF name would be "The Smith Family Foundation". Non-cash assets are usually converted to cash, and the fund's assets are then invested in accordance with the charity's investment policies.

Anyone can make additional gifts to a DAF. Once established, a donor can make a grant recommendation — often, the very same day. Donors can also advise that the charity make predetermined gifts of either a fixed amount or fixed percentage indefinitely to a specified charity or charities. After receiving grant recommendations, most charities confirm the recipient organization's tax-exempt status and other eligibility criteria, and then process the grant.

The grant check, in the name of the DAF, is mailed to the approved organization by the charity.

## Charitable Lead Trusts

### General Description of Charitable Lead Trusts

A charitable lead trust (CLT) is, in some ways, the mirror image of a charitable remainder trust. **It provides for a gift of income to charity for a period of time with the remainder either returning to the donor or passing to non-charitable beneficiaries.** The two principal types of charitable lead trusts are:

#### Grantor Lead Trusts

The tax objective of a grantor lead trust is to obtain a current income tax deduction equal to the actuarial value of the charitable income interest. To accomplish this goal, the trust **income must be taxable to the grantor** even if all or part of that income is paid to the charitable beneficiary.

#### Non-grantor Lead Trusts

The more widely used non-grantor charitable lead trust is designed to provide income to charity for a specified term and then pass the property to non-charitable beneficiaries (e.g., children and grandchildren) at little or no transfer tax cost.

CLTs were particularly effective when prevailing interest rates were high relative to the 6% assumed rate of return in the actuarial tables prescribed by the IRS prior to December 1983. The promulgation of actuarial tables adjusted monthly by the IRS has diminished the dramatic tax savings from lead trusts, but in a given case, e.g., a low interest rate environment, a lead trust still may offer an attractive opportunity to fulfill a donor's charitable commitments and save taxes, especially when the trust is funded with property that has significant growth potential (appreciation in value).

In contrast to charitable remainder trusts, which are required by IRC § 664 to pay a minimum of 5% each year, CLTs have no minimum or maximum payout requirements. The primary issue with a CLT is the length of time and payout to charity desired for planning purposes; the charitable deduction benefit is greater for larger payouts or longer terms because more income is distributed to charity. Calculation of the deductions for income, gift and estate tax purposes are done in accordance with the principles established in IRC § 7520, as further described in IRS Publications 1457 and 1458.

## Grantor Lead Trusts

To obtain a current income tax deduction on the creation of a CLT, the donor must be treated as the owner of the trust under the grantor trust rules. See IRC §§ 170(f)(2)(B). A grantor lead trust is most useful to a donor seeking to obtain a current income tax charitable deduction in a year when his or her marginal income tax rate is unusually high. Grantor lead trusts have little appeal when tax rates are relatively flat or are increasing gradually over time because the trade-off for a current income tax deduction is that the donor will be taxed on the trust income at a higher rate during the term of the trust even though she does not receive the income.

If, however, a donor's tax rate is expected to be lower in the future, the present value of the current deduction may outweigh the present value of the future tax liability on the trust income. It is important to note that the grantor lead trust is designed for **income tax savings only**; it generally is not a suitable vehicle for wealth transfer tax savings because the trust is taxable to the grantor.

The principal features of the grantor lead trust are as follows:

- To qualify for an income tax charitable deduction, the trust must provide for payment to a specified charity or charities not less than annually. The payments must be in the form of a fixed annuity or a unitrust interest, i.e., a fixed percentage of the trust property, valued annually.
- The income tax deduction is the present actuarial value of the total annual payments to charity over the term of the trust.

- The charitable lead interest is a gift “for the use of” the charity. As such, even a gift of cash to a grantor lead trust is subject to the 30% basic limitation rather than the 50% limitation. If the limitation applies, a five-year carryover is available for any excess deductible amount. See *Section 1.C. for an explanation of these percentage limitations.*
- During the term of the trust, the income is fully taxable to the donor without any offsetting charitable deduction. This problem can be avoided by investing the trust assets in tax-exempt municipal bonds.
- If the donor dies or ceases to be treated as the owner of the trust, there will be a “recapture” of all or part of the initial charitable deduction.
- The charitable lead interest qualifies for the gift tax charitable deduction. If the trust assets revert to the grantor or his or her spouse, the creation of a grantor lead trust does not result in any taxable gift for gift tax purposes.
- The trust is subject to many of the rules governing private foundations, including the prohibition against “excess business holdings” and “jeopardy investments,” except that these prohibitions do not apply where all of the income interest (and none of the remainder interest) is devoted solely to a qualified charitable beneficiary and all amounts in the trust for which a charitable deduction was allowed have an aggregate value of not more than 60% of the aggregate fair market value of all amounts in the trust. In all events, however, the prohibitions on “self dealing” apply. For more details on the excise taxes applicable to private foundations, see IRC §§ 4940-4945.

## Non-grantor Lead Trusts

The non-grantor lead trust **does not provide a current income tax deduction**, but it may be a useful technique for shifting wealth to younger generations (especially with a highly appreciating asset).

If structured properly, the non-grantor lead trust allows a donor to benefit a favored charity and then pass the property, either outright or in a continuing trust, to children or grandchildren at little or no transfer tax cost. If a non-grantor lead trust is established during the donor’s lifetime, a **current gift tax deduction** is available for the actuarial value of the charitable lead interest. The remainder interest passing to non-charitable beneficiaries is a taxable gift, but as described below, synchronizing the charitable payout with the term of the trust may minimize it. The principal features of a non-grantor charitable lead trust are:

- **The charitable lead interest must be in the form of a qualified annuity trust or unitrust.** Unlike charitable remainder trusts, there is no requirement that the annual payments to charity be at least 5%.

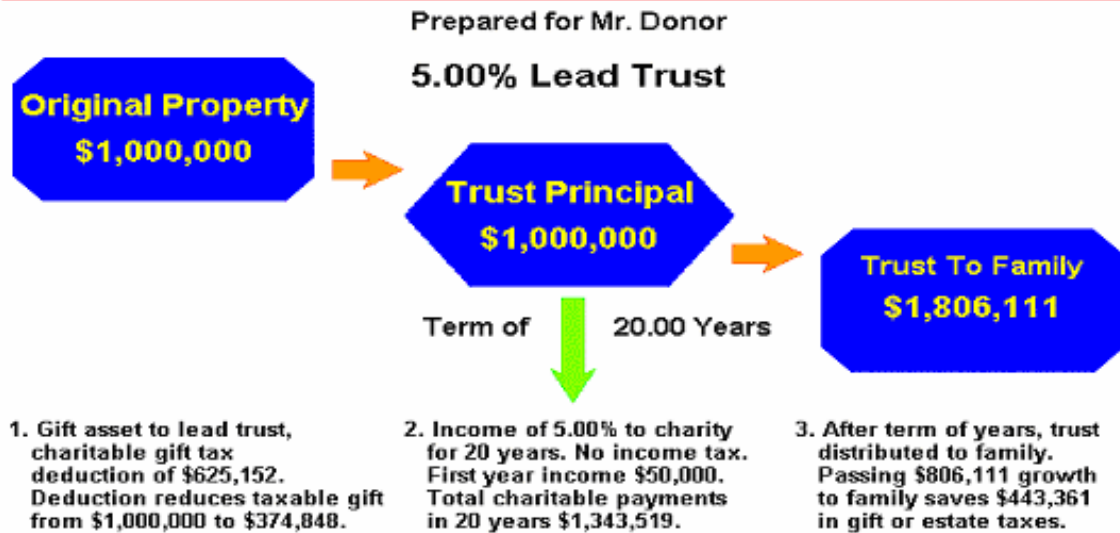
- If a CLT is established at the donor's death, the donor's estate is entitled to an estate tax charitable deduction for the value of the charitable lead interest.
- **The value of the non-charitable remainder is a taxable gift (or bequest) when the trust is established.** The amount of the gift equals the value of the property transferred to the trust reduced by the actuarial value of the charitable lead interest. If the trust provides for a high payout, the value of the remainder interest may be eliminated. For example, an annuity of 9% of the initial value of the trust assets payable to charity over a term of 20 years will reduce the value of the remainder interest to zero if the IRS's applicable interest rate is 6.6% in the month of the gift.
- An important aspect of the non-grantor lead trust is that any appreciation in the value of the assets placed in the trust passes to the non-charitable beneficiary without being subject to any further gift or estate tax.
- The income of a non-grantor lead trust is taxable to the trust with a corresponding charitable income tax deduction (without any percentage limitations) for amounts required to be paid to the charitable beneficiary. The grantor is not taxed on the trust income. Non-grantor trusts may be subject to the alternative minimum tax.
- CLTs established for the ultimate benefit of grandchildren may have generation-skipping transfer tax (GSTT) consequences. In general, no GSTT will be due when a CLT is funded (although the value of the non-charitable remainder will be a taxable gift at that time). When a charitable lead interest terminates and the property in trust passes to the grantor's grandchildren or great-grandchildren, a GSTT may be due unless the grantor has properly allocated his or her \$1,000,000 GSTT exemption. The allocation of a donor's GSTT exemption to a CLT is complex, particularly in the case of a charitable lead annuity trust where the allocation is not made until the end of the charitable payout period. No CLT should be created for the ultimate benefit of persons two generations or more below the grantor's generation without a careful consideration of the impact of the GSTT.
- Non-grantor lead trusts are subject to the private foundation rules and restrictions that are described above in connection with grantor lead trusts.

**For more details, see IRC §§ 170(f)(2)(B), 2522(c)(2), 2055(e)(2), 642(c) and accompanying regulations.**

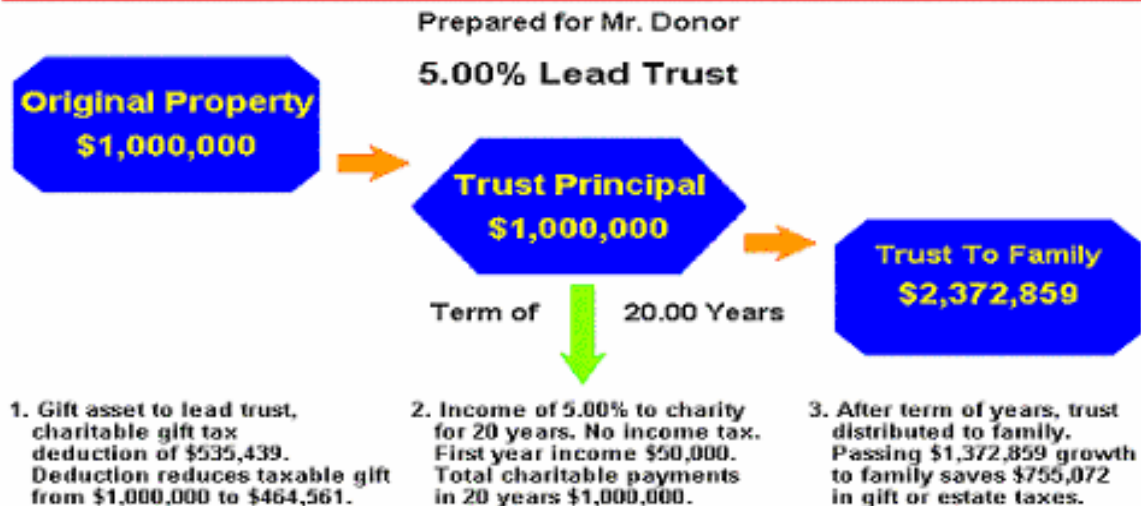
## Illustrations

- (1) Twenty-year 5% Living CLUT
- (2) Twenty-year 5% Living CLAT

### UNITRUST LEAD TRUST



### ANNUITY LEAD TRUST



The two previous examples require a little explanation. First the examples are non-grantor lead trusts. Second, readers will notice that the gift tax deductions (item 1.) in both examples are different, the income (item 2.) in both examples are different and in item 3. the ultimate amount of money transferred to the heirs is different.

The gift tax deductions in both the Unitrust and Annuity trust are based on assumed amounts of income transferred to charity every year. In the Unitrust example, the income paid to the charity starts at \$50,000 and increases annually. With the Annuity trust, the income is a level \$50,000 for 20 years. Because the total amount paid to the charity is over the 20 year period is higher with the Unitrust, the deduction for the client making the gift is higher.

The reason the income (item 2.) **is higher with the Unitrust** is due to the fact that the 5% return on the assets gifted to the trust is based on the **assumption that the trust investments will actually exceed a 5% annual rate of return**. Therefore, as the 5% gift is calculated each year it is calculated on assets of increasing value which, in turn, creates a higher gift each year to the charity.

With the Annuity Trust, the 5% rate of return is based on the initial gift and pays a level amount based on that initial gift every year for 20 years (which is easy to calculate: 20 years X \$50,000 = \$1,000,000).

In either case, the heirs receive whatever is left in the CLT after the payment period is over. Because the Unitrust pays out more income each year, there is less left at the end of the period to transfer to the heirs. A good rule of thumb is that if the client is trying to maximize the gift to a charity, the client will use a Unitrust; and if the client is looking to pass the maximum amount of money to the heirs, the client will use an Annuity trust.

## Private Foundations

To fulfill one's charitable goals, there may be times that the establishment of a private foundation will be the entity of choice. Like a public charity, a private foundation must be operated for public purposes, i.e., exclusively for religious, charitable, scientific, literary or educational purposes. Generally, the private foundation will be exempt from income tax, and contributions to a private foundation will be deductible for income tax, gift tax and estate tax purposes.

Private foundations differ from public charities insofar as a private foundation often has only one source of funding (usually one person or family), does not engage in direct charitable activities (it makes grants to other charities to perform public service), and the funds available for grants and administrative expenses come from income generated from the investment of the assets

comprising the private foundation. There are two distinct differences normally associated with private foundations when comparing them to public charities.

The first difference relates to the annual limitation on the federal income tax deduction available for donations made to a private foundation. For example, when cash gifts are made to a **public charity**, the donor is entitled to a deduction in that year of an amount not exceeding fifty percent (50%) of the donor's adjusted gross income. Any unused charitable income tax deduction can be carried over for five subsequent years.

Cash donations made to a **private foundation** may only be deducted in the year of contribution to the extent of thirty percent (30%) of the donor's adjusted gross income, although the unused portion of such charitable income tax deduction may be carried forward for five subsequent years (although still subject in each of those subsequent years to the thirty percent (30%) of adjusted gross income limitation).

The annual deduction limit of gifts of appreciated capital property, such as real estate or marketable securities, whose current fair market value exceeds the donor's adjusted basis, when donated to a public charity, is limited to thirty percent (30%) of the donor's adjusted gross income, whereas the limitation for the donation of appreciated capital property to a private foundation is twenty percent (20%) of the donor's adjusted gross income.

The second difference relates to the special requirements and excise taxes imposed pursuant to Sections 4940 through 4945 of the Internal Revenue Code of 1986, as amended (the "Code"). Because of what the IRS perceived to be abuses of the use of the tax-exempt status of private foundations, Congress enacted a system of alternative penalty taxes that can be imposed against the private foundation and, under certain circumstances, against the manager of the private foundation. The system of penalty taxes is intended to ensure that both public charities and private foundations are organized and operated so that no part of the organization's earnings inure to the benefit of any private shareholder or individual.

Section 4940 of the Code requires each private foundation to pay an annual excise tax equal to two percent (2%) of its net investment income. Net investment income includes interest, dividends, rents, royalties, long-term capital gains and short-term capital gain. The two percent (2%) excise tax can be reduced to one percent (1%) if the qualifying distributions for charitable purposes made by the private foundation are increased by an equivalent amount.

Section 4941 of the Code prohibits the private foundation from entering into financial transactions with persons characterized as "disqualified persons." These include individuals who are members of the board of directors or trustees of a private foundation, foundation managers, substantial contributors to the private foundation, and certain family members of the afore described individuals.

The prohibition against acts of self-dealing applies even if the transaction is fair and reasonable, or economically benefits the private foundation.

Prohibited transactions include selling, exchanging, releasing property, lending money or extending credit, and furnishing goods, services, or facilities. The payment of reasonable compensation and the reimbursement of reasonable expenses are specifically excepted from the prohibition, but the Internal Revenue Service scrutinizes compensation paid to disqualified persons and expenses reimbursed to disqualified persons. The self-dealing penalty tax is imposed on the disqualified person at the rate of five percent (5%) of the amount involved. A penalty tax of two hundred percent (200%) of the amount involved is imposed if the self-dealing act is not corrected within a prescribed period of time.

**Section 4942 of the Code imposes a penalty tax in the event that a private foundation does not pay, on an annual basis, an amount equal to five percent (5%) of its investment assets in the form of qualifying distributions.** For example, a private foundation with investment assets of \$500,000 is required to make qualifying distributions of at least \$25,000 for that year ( $\$500,000 \times 5\%$ ). The qualifying distributions must be made within twelve months after the end of the previous tax year, and must be made to public charities which are not controlled by the private foundation or its disqualified persons. Administrative expenses which are reasonable and necessary to accomplish the charitable purposes of the private foundation may be included in the calculation of qualifying distributions. If the private foundation fails to meet this distribution requirement, an initial penalty tax of fifteen percent (15%) will be imposed on the shortfall.

Section 4943 of the Code prohibits a private foundation from controlling a business entity. In general terms, a private foundation may not own more than twenty percent (20%) ownership interest in any business entity. Under certain circumstances, that percentage limitation may be increased to thirty-five percent (35%) if effective control of the business entity rests with one or more persons who are not disqualified persons. The interests in the business entity owned by disqualified persons are aggregated with the interests owned by the private foundation for purposes of determining whether the percentage limitations have been exceeded unless the private foundation itself owns less than two percent (2%) of the outstanding business interest.

In the event that more than a twenty percent (20%) ownership in a business entity is contributed to a private foundation, the private foundation is provided with a five year window to divest itself of enough of its interest to reduce its ownership to twenty percent (20%) or less. If, after five years, the ownership is still greater than twenty percent (20%), the private foundation will be subject to an initial tax of five percent (5%) of the amount held in excess of the twenty percent (20%) limitation.

Section 4944 of the Code prohibits any investment by a private foundation that might jeopardize the private foundation's exempt purpose. An investment is generally considered to be in violation of this prohibition if a determination is made that the board of directors or trustees failed to exercise ordinary business care and prudence in making the investment. An initial tax of five percent (5%) of the amount of the investment will be assessed against the private foundation for any such violation. Furthermore, a tax of five percent (5%) may also be assessed against the foundation manager.

Section 4945 of the Code prohibits certain activities that may promote the contributors' interests rather than interests of the public. A penalty tax is imposed on what is referred to as "taxable expenditures." Taxable expenditures include expenditures made in conjunction with carrying on propaganda or otherwise attempting to influence legislation, attempting to influence the outcome of any special election, making grants to individuals without objective and nondiscriminatory procedures that have been approved in advance by the IRS, making grants to entities other than public charities unless the private foundation exercises expenditure responsibility over the grants, and the making of grants for non-charitable purposes. If a private foundation makes taxable expenditures, a tax on the amount of the taxable expenditure is imposed at the rate of ten percent (10%) on the private foundation and two and one-half percent (2½%) on a foundation manager who knowingly approved the taxable expenditure. Additional taxes of one hundred percent (100%) may be imposed on the private foundation (and fifty percent (50%) on the foundation manager) on the amount of the taxable expenditure if the taxable expenditure is not timely corrected.

Generally, private foundations take the form of either a corporate entity or a trust. The choice is often affected by state law and the specific objectives of the individual wishing to create the private foundation.

There are several types of private foundations, including non-operating foundations, operating foundations and pass-through (conduit) foundations. The selection of the specific type of private foundation to be formed will be determined by the goals and objectives of the individual establishing the private foundation.

Private foundations can be funded through direct contributions as well as contributions that occur through a charitable lead trust or a charitable remainder trust. Moreover, private foundations can be created as a result of testamentary distribution, such as a devise pursuant to a will or an inter-vivos trust upon the death of the trust's grantor.

A private foundation can provide a fulfilling medium for individuals who wish to engage in charitable pursuits in a business-like manner, while **maintaining control** and flexibility over their charitable endeavors. It is important that the individuals managing the private foundation pay close attention to the complex rules governing its operation so that neither the private foundation nor

individuals closely associated with the private foundation will incur unnecessary excise taxes or cause the private foundation to lose its tax-exempt status. Therefore, individuals establishing or managing private foundations must surround themselves with qualified professional advisors.

## What is the difference between a Private Foundation (PF) and a CGA/CRAT?

The main difference in my mind between a PF and a CGA and CRAT is **cost**. The setup costs of a CGA are ZERO and is less than \$2,500, typically, for a CRAT . The setup costs of a PF are between \$10,000-\$15,000. More importantly, when a client contributes to a PF there are additional limits on the deductions they can take against personal income. The limit differences are as follows:

Income Tax Deduction for Donor	<u>CGA/CRAT</u>	<u>Private Foundation</u>
<u>Cash Gift</u> income	50% of Adjusted Gross Income	30% of adjusted gross income
<u>Property/Securities</u> income	30% of Adjusted Gross Income	20% of adjusted gross income

A good rule of thumb is that unless a client has a strong desire to control the money gifted to charity, the client should use a CGA or CRAT due to the lower setup costs and higher income tax deduction.

## Summary on Charitable Giving

Because clients, for the most part, do not go out of their way to incorporate charitable planning, most advisors are not in the habit of bringing it up as a viable estate planning solution. The lack of demand from clients and the perception that charitable planning is charity focused creates a scenario where only charitable experts are recommending charitable planning to their clients.

Simplified Planned Giving (SPG) allows advisors to present charitable planning in a light that is client focused, where the benefits initiate with what charitable planning can do for the client. Because of the nature of any charitable plan, charities will ultimately benefit, but is it nice to be able to show clients how they can benefit as well. SPG can help advisors open their clients eyes to the benefits of charitable planning which, in turn, will help any advisor grow their practice and provide better planning solutions for the clients.